BEFORE THE STATE TAX APPEAL BOARD

OF THE STATE OF MONTANA

GRANDVIEW PLAZA	)	
	)	DOCKET NO.: PT-1994-50 &
Appellant,	)	PT-1995-1R
	)	
-vs-	)	
	)	ORDER ON REMAND
	)	
THE DEPARTMENT OF REVENUE	)	FINDINGS OF FACT,
OF THE STATE OF MONTANA,	)	CONCLUSIONS OF LAW,
	)	ORDER and OPPORTUNITY
Respondent.	)	FOR JUDICIAL REVIEW

The above-entitled appeal came before the Montana State Tax Appeal Board (the Board) for hearing on remand on the 27th day of January, 1998, in the City of Helena, Montana, pursuant to the Remand Order of Judge Jeffery Sherlock, Montana First Judicial District, Lewis and Clark County. The notice of the hearing was given as required by law. The Department of Revenue (DOR) was represented by attorney Pat Dringman and Rich Dempsey, commercial appraiser. The taxpayer was represented by agent Don McBurney. At this time and place, evidence and testimony was presented.

STATEMENT OF THE ISSUES BEFORE THE BOARD

The District Court Order of Remand instructed this Board:

- to establish the value of the subject property based upon the income approach to value; and, in the event it is determined the DOR is unable to apply the income approach to value, state the reasons why the income approach could not be used; and

- to make specific findings on the issue of whether the petitioner is entitled to consideration of the governmental restrictions in determining market value for the subject property under the cost method of appraisal and, if so, the decision is to reflect how the governmental restrictions are factored into its valuation.

FINDINGS OF FACT

1. Due, proper and sufficient notice was given of this matter, the hearing hereon, and of the time and place of the hearing. The parties were afforded opportunity to present further evidence and testimony, related to the Order of Remand.

2. The market value for the subject property was determined by the DOR by the cost approach to value.

3. The DOR's original appraised value was $144,960 for the land and $2,115,100 for the improvements.

4. The Cascade County Tax Appeal Board reduced the

value of the improvements to $2,087,800, and the value of the land remained at $144,960.

5. DOR's exhibits presented in the remand hearing illustrate the value of the subject property from the cost approach as $2,087,800. This value indication is from the decision of the local board for the improvements only. The DOR has understated the total market value by excluding the land value. The total value of the subject property from local board's decision is $2,232,760 (land - $144,960; improvements - $2,087,800).

6. This Board's decision dated February 15, 1996 ordered the removal of the Economic Condition Factor (ECF) of 109%; applied to the value of the improvements determined by the cost approach.

7. The removal of the 109% ECF indicates a value of $1,899,898 for the improvements.

8. The DOR did not seek judicial review of this Board's decision; therefore, the value before the District Court was $144,960 for the land and $1,899,898 for the improvements.

9. The value before this Board subject to the Remand Order is $144,960 for the land and $1,899,898 for the

improvements.

10. Petition for Judicial Review was filed with the First Judicial District on April 8, 1996. Grandview Plaza, A Montana Limited Partnership v. Department of Revenue of the State of Montana, Cause No. BVD-96-439.

11. The Board's Order was remanded for further evidentiary findings on November 13, 1997. Grandview Plaza, A Montana Limited Partnership v. Department of Revenue of the State of Montana, Cause No. BVD-96-439.

12. Exhibits presented in the hearing on remand have been prefaced by the letter "R" to differentiate exhibits from the previous hearing.

DOR CONTENTIONS

1. DOR exhibit R-A is an income approach to value for the subject property. Mr. Dempsey testified that when establishing the market rent for this exhibit the Rowen and Polton appraisals were used. (exhibits R-C & R-D)

2. DOR exhibit R-F is a list of 29 sales of multi-family properties. Mr. Dempsey testified that these sales were identified to establish an overall capitalization rate of 12.5% which was used in capitalizing the net operating income.

3. DOR exhibit R-G is an income approach prepared

for the subject property considering actual rents, other income, a financing benefit and a utility benefit. Mr. Dempsey testified that the expenses utilized in this exhibit came from the Rowen appraisal, exhibit R-C, and that some of the expenses recognized by Rowen were not considered allowable by the DOR.

4. Mr. Dempsey testified that he spoke with a person from the management company with regards to the mortgage payment. He was told the total monthly payment is $7,998 and HUD subsidizes all but $2,482. In determining the financing benefit the payments were annualized. A mathematical error was discovered by the Board within this exhibit and the corrected calculations are as follows:

Monthly Payment	Annual Payment
$7,998	$95,976
$2,482	$29,784
Yearly Benefit:	$66,192

5. Mr. Dempsey testified that the income approach value determination from exhibit R-A provides support for the value determined by the cost approach. The income value illustrated on this exhibit is $2,158,785 and the cost value is $2,087,800.

6. Mr. Dempsey testified that an effective tax rate has been included in the overall capitalization rate of 12.5%.

7. Mr. Dempsey testified that he was not the original appraiser who determined the market value from the cost approach for the subject property.

8. Mr. Dempsey testified income approach valuations were performed by the DOR to illustrate support for the cost approach. Cascade County did not have an income model in place to determine values from income approach to valuation for apartment property.

9. Exhibit R-J is an income approach valuation for the subject property which does not consider a utility income benefit. The value indication from this exhibit is $1,788,278.

TAXPAYER'S CONTENTIONS

1. Mr. McBurney testified that the competency provisions as outlined within the Uniform Standards of Professional Appraisal Practice (USPAP) have not been satisfied by the DOR.

2. Mr. McBurney testified that DOR exhibit R-H is incorrect, inasmuch as the interest rate is 7% and the amount of the mortgage is $1,287,000.

3. Mr. McBurney testified that the management fee for the subject property is 11.5% and must be negotiated with the management company and owner of the property.

4. Mr. McBurney testified that the burden of proof was not met by the DOR evidenced by the number of errors in the presentation of their income approaches to value.

BOARD'S DISCUSSION

The Courts Remand Order has directed this Board to address the following:

- to establish the value of the subject property based upon the income approach to value; and, in the event it is determined the DOR is unable to apply the income approach to value, state the reasons why the income approach could not be used; and

- to make specific findings on the issue of whether the petitioner is entitled to consideration of the governmental restrictions in determining market value for the subject property under the cost method of appraisal and, if so, the decision is to reflect how the governmental restrictions are factored into its valuation.

The Board has taken administrative notice of the evidence and testimony presented in the remand hearing, Collins Construction v. DOR, PT-1994-36, as it pertains to the Order of Remand.

Neither party presented to the Board sales of low income housing projects other than a distressed sale in Cut Bank, Montana as testified to by Mr. McBurney. A direct sales comparison could not be made between market rate and low income housing projects to determine if or how the government encumbrances/restrictions have affected the market value; therefore, this Board has taken the approach of examining the market value determination from an income approach and comparing that to the value indication from the cost approach.

The DOR has presented this Board with three separate values derived from the income approach to value. The following table is a recreation of the DOR's value indications along with the tangible value indication from the Polton appraisal (exhibits R-A, R-G , R-J and 18).

A second table illustrates the value indications from the Rowen and Johnson appraisals which were performed for the purposes of retaining the subject property in the low-income housing program (exhibits 12 and G). In addition, the value indication from the income approach found in the Polton appraisal recognizing the market rate analysis is included.

Exhibit#	DOR R-A		DOR R-G		DOR R-J		TP #18 Polton Report	
Expenses(SF)	$1.285	Management - 8%	$1.248	Management - 8%	$1.248	Management - 8%	$2.33	Management- unk
Size (SF)	82,764	98 apt units	82,764	98 apt units	82,764	98 apt units	81,609	96 apt units
	Apts	Mo. Rent	Apts	Mo. Rent	Apts	Mo. Rent	Apts	Mo. Rent
1 bedroom	48	$335	48	$229	48	$229	48	$259
2 bedroom	38	$375	38	$264	38	$264	36	$296
3 bedroom	12	$400	12	$301	12	$301	12	$340
INCOME								
Total monthly rental income	$35,130		$24,636		$24,636		$27,168	

Annualized	X 12			X 12			X 12			X 12		
Total	$421,560			$295,632			$295,632			$326,016		
Other income	$0			$9,169			$8,480			$12,650		
Financing benefit	$0			$62,136			$62,136			$0		
Utility Allowance	$0			$55,300			$0			$0		
Potential Gross Income (PGI)	$421,560			$422,237			$366,248			$338,666		
Occupancy	97%			97%			97%			97%		
Effective Gross Income (EGI)	$408,913			$409,570			$355,261			$328,506		
EXPENSES		% of EGI	$/SF		% of EGI	$/SF		% of EGI	$/SF		% of EGI	$/SF
Management	($32,713)	8%	$0.40	($32,766)	8%	$0.40	($28,421)	8%	$0.34	unk		
Expenses	($106,352)	26%	$1.29	($103,305)	25%	$1.25	($103,305)	29%	$1.25	($190,534)	58%	$2.33
Total Expenses	($139,065)	34%	$1.68	($136,071)	33%	$1.64	($131,726)	37%	$1.59	($190,534)	58%	$2.33
Net Operating Income (NOI)	$269,848	66%	$3.26	$273,499	67%	$3.30	$223,535	63%	$2.70	$137,973	42%	$1.69
CAPITALIZATION												
Capitalization rate (OAR)		DOR exhibit calculates a $ per apt. unit based on 96 apt. units.			DOR exhibit calculates a $ per apt. unit based on 96 apt. units.			DOR exhibit calculates a $ per apt. unit based on 96 apt. units.		9.09%		
Effective tax rate										1.65%		
Total Rate	12.50%			12.50%			12.50%			10.74%		
Value Indications		**$/per apt**	**$/SF**		**$/per apt**	**$/SF**		**$/per apt**	**$/SF**		**$/per apt**	**$/SF**
Income - NOI/Total rate	**$2,158,785**	**$22,487**	**$26.08**	**$2,187,994**	**$22,971**	**$26.44**	**$1,788,278**	**$18,627**	**$21.61**	**$1,284,665**	**$13,382**	**$15.74**

Cost Value	**$2,087,800**	**$21,748**	**$25.23**	**$2,087,800**	**$21,748**	**$25.23**	**$2,087,800**	**$21,748**	**$25.23**			

Exhibit#	TP - #12 - Rowen			DOR G - Johnson			TP - #18 - Polton		
Purpose of appraisal	Preservation Value			Preservation Value			Intangible Value		
Expenses(SF)	$2.27	Management - 6%		$2.57	Management - 4%		$3.22	Management-unk	
Size (SF)	83,630	96 apt units		70,319	96 apt units		81,609	96 apt units	
	Apts	Mo. Rent		Apts	Mo. Rent		Apts	Mo. Rent	
1 bedroom	48	$335		48	$350		48	$450	
2 bedroom	36	$375		36	$450		36	$525	
3 bedroom	12	$400		12	$510		12	$625	
INCOME									
Total monthly rental income	$34,380			$39,570			$48,000		
Annualized	X 12			X 12			X 12		
Total	$412,560			$474,840			$576,000		
Other income	$1,350			$5,820			$8,480		
Potential Gross Income (PGI)	$413,910			$480,660			$584,480		
Occupancy	98%			95%			95%		

Effective Gross Income (EGI)	$405,659			$456,627			$555,256		
EXPENSES		% of EGI	$/SF		% of EGI	$/SF		% of EGI	$/SF
Management	($24,753)	6%	$0.30	($18,265)	4%	$0.26	unk		
Expenses	($165,331)	41%	$1.98	($162,446)	36%	$2.31	($263,016)	47%	$3.22
Total Expenses	($190,084)	47%	$2.27	($180,711)	40%	$2.57	($263,016)	47%	$3.22
Net Operating Income (NOI)	$215,575	53%	$2.58	$275,916	60%	$3.92	$292,240	53%	$3.58
CAPITALIZATION		Real estate taxes have been included in the expenses.			Real estate taxes have been included in the expenses.			Real estate taxes considered in the effective tax rate.	
Capitalization rate (OAR)	10.79%			9.5%			10.25%		
Effective tax rate							1.65%		
Total Rate	10.79%			9.5%			11.90%		
Value Indication		**$/per apt**	**$/SF**		**$/per apt**	**$/SF**		**$/per apt**	**$/SF**
Income - NOI/Total rate	**$1,997,691**	**$20,809**	**$23.89**	**$2,910,000**	**$30,000**	**$41.38**	**$2,455,798**	**$25,581**	**$30.09**

Based on the evidence and testimony presented, it is determined that there are 96 rental apartment units and 1 on-site manager living unit. The DOR's exhibits illustrate income generated from 98 rental units. For valuation purposes from the income approach, 96 income producing rental units will be considered.

As testified to by the DOR, the income information illustrated in exhibits R-A, R-G and R-J was extracted from the Rowen and Polton appraisals. Exhibit R-A's income assumes unencumbered rents and exhibits R-G and R-J recognize the encumbered rents. The Polton appraisal (pg. 27, ex. 18) describes the rent allowed by HUD as follows:

Unit Type	Minimum Rent	Maximum Rent	Average Rent
One Bedroom	$229	$289	$259
Two Bedroom	$264	$333	$296
Three Bedroom	$301	$379	$340

The DOR used the minimum rent allowed by HUD and Mr. Polton used the average. The tenants pay 30% of their adjusted gross income towards rent and utilities. Based on those guidelines, it is anticipated that the tenant's rents will vary. Mr. Dempsey testified to an additional income of $55,000 for a utility allowance as illustrated in exhibit R-G. There was no evidence presented that would indicate this allowance exists.

The DOR's financing benefit of $62,136, as illustrated on exhibit R-H, was calculated incorrectly. It was testified to by Mr. McBurney that the terms of the mortgage are: loan amount - $1,287,000, term - 40 years, interest rate - 7%. When recalculating based on this information, the financing benefit is as follows:

Loan Amount	Rate	Term	Annual Payment
$1,287,000	7%	40 yrs	$95,974
$1,287,000	1%	40 yrs	$39,051
	Financing Benefit:		$56,923

The financing benefit has been overstated by the DOR on exhibits R-G and R-J by $9,269.

The financing benefit has been reduced by the vacancy factor of 3%. It is the Board's opinion that this benefit should not be adjusted by the vacancy factor but rather should be applied to the effective gross income.

As testified to by the DOR, the overall capitalization rate of 12.5% was derived from sales as illustrated on exhibit R-F. Mr. Dempsey testified that he was not the author of this exhibit nor was he a commercial appraiser when this exhibit was created. The 12.5%

capitalization rate is an average from all 29 sales. In calculating the capitalization rate for each sale, it was ascertained that overall capitalization rates range from a low of -.34% to a high of 27%. When capitalization rates have this wide of a variance, it is assumed further sales verifications are in order to determine if the sales should be considered. It is the Board's opinion that this method of averaging to determine a capitalization rate is unsupportable. In addition, the exhibit presents data on properties with the number of units ranging from 2 to 24, the average being 4.4 units, while the subject property consists of 96 apartment units. Mr. Dempsey testified that the effective tax rate has been included in the 12.5% cap rate. There is nothing illustrated on this exhibit to support that an effective tax rate has been recognized.

The Board does not dispute that capitalization rates can be extracted from the market and may be the best indicator of what investors anticipate, but there are other methods available to appraisers to determine capitalization rates and provide support, i.e. band of investment, debt coverage ratio, etc. The DOR provided no additional support for their capitalization rate; therefore, the Board finds no justification for the DOR's development of a 12.5% overall capitalization rate from this exhibit.

Taxpayer's exhibit 18, the Polton appraisal, is an appraisal for the subject property. Mr. Polton was retained by Mr. McBurney to appraise the subject property for assessment purposes. Mr. Polton's final value determination is $1,285,000. Mr. Polton determined tangible and intangible values for the property. The definitions of these values used in the report are as follows:

> <u>Tangible Value</u> - Property that can be perceived with the senses; includes land, fixed improvements, furnishings, merchandise, cash, and other items of working capital used in an enterprise.
>
> <u>Intangible Value</u> - A value that cannot be imputed to any part of the physical property, e.g. the excess value attributable to a favorable lease or mortgage, the value attributable to goodwill.

His appraisal states further,

> ...the Appraisal Standards Board of the Appraisal Foundation note the distinction in the "Proposed Advisory Opinion - 11-01-94" for the Uniform Standards of Professional Appraisal Standards under the section entitled <u>Property Rights Issues.</u> The Proposed Advisory Opinion States:
>
> > "Subsidies that create affordable housing may also create intangible property rights in addition to real property rights and/or restrictions that modify real property rights."

Further research by the Board on this issue of valuing low income properties or subsidized housing, Uniform

Standards of Professional Appraisal Practice (USPAP), Advisory Opinion AO-14 states:

> SUBJECT: Appraisals for Subsidized Housing
>
> Property Rights Issues
>
> Subsidies and incentives that encourage housing for low- and moderate-income households may create intangible property rights in addition to real property rights and also create restrictions that modify real property rights. The appraiser should demonstrate the ability to discern the differences between the real and intangible property rights and value the various rights involved. Low-Income Housing Tax Credits (LIHTCs) are an example of an incentive that results in intangible property rights that are not real property but might be included in the appraisal. Project-based rent subsidies are an example of a subsidy accompanied by restrictions that modify real property rights. Appraisers should be aware that tenant-based rent subsidies do not automatically result in a property right to the owner or developer of subsidized housing. (emphasis added)
>
> Standards Rule 1-2(e) allows the inclusion of intangible assets that are not real property in the appraisal and, if they are significant to the overall value, the intangible value should be reported separately. One way to measure the significance of the intangible assets is to estimate the value including the intangibles and to compare the results with an estimate of value excluding the intangibles. (emphasis added) Additional guidance is provided in the Comment section of Standards Rule 1-2(e).
>
> A critical factor in all subsidized housing appraisals is the analysis of whether or not the various subsidies, incentives and restrictions remain with the real property following a sale or foreclosure and are marketable property rights to be included in the appraisal. (emphasis added)
>
> Value Definition Issues
>
> The value definition in any appraisal is a controlling factor of the bundle of rights to be considered in the valuation. Standards Rule 1-2(b) requires an appraiser to define the value being considered. Standards Rule 1-2(b) further states, if the value to be estimated is market value the appraiser must clearly indicate whether the estimate is the most probable price:

I. in terms of cash; or

ii. in terms of financial arrangements equivalent to cash; or

iii. <u>in such other terms as may be precisely defined; if an estimate of value is based on submarket financing with unusual conditions or incentives, the terms of such financing must be clearly set forth, their contributions to or negative influence on value must be described and estimated, and the market data supporting the valuation estimate must be described and explained.</u> (emphasis added)

If the appraisal of a subsidized housing assignment is for market value, the appraiser must determine if requirement (I), (ii), or (iii) above applies to the specific definition selected or required by the client. The appraiser can then determine if the programs and intangible assets created by the programs affecting the subject property qualify under the selected or required market value definition. This determination requires competent knowledge of the programs and whether the programs qualify under (I), (ii), or (iii) above.

USPAP does not mandate market value appraisals, but does require that the value be defined. If the defined value for the total property (real property and intangible assets) is not market value, then (I), (ii), and (iii) above may not be applicable. Additional guidance is provided in the Comment sections of Standards Rules 1-2(b) and 1-2(e).

The Glossary of USPAP recognizes there are numerous definitions of market value. The Glossary includes one commonly used market value definition, which is the definition agreed upon by agencies that regulate federal financial institutions in the United States. Implicit in this definition is the consummation of a sale under a condition that the price represents the normal consideration for the property sold unaffected by special or creative financing or sales concessions granted by anyone associated with the sale.

In appraisal of subsidized housing the value definition selected or required by the client and the reporting techniques should be discussed with the client prior to the acceptance of the assignment because the analyses may be based on general market terms, subsidized housing submarket financing with unusual conditions or incentives, both, or some other defined premise.

Because Standards Rule 1-2(b) also states that the terms of submarket financing or financing with unusual conditions or incentives must be clearly set forth, their contributions to or negative influence on value must be described and estimated. (emphasis added)

Subsidies and incentives should be explained in the appraisal report and their impact on value, if any, needs to be reported in conformity with the Comment section of Standards Rule 1-2(e), which states "Separate valuation of such items is required when they are significant to the overall value (emphasis added)

Appraisers should be aware that appraisal of subsidized housing usually requires more than one value analysis predicated on different scenarios. In appraisal of subsidized housing, value conclusions that include the intangibles arising from the programs will also have to be analyzed under a scenario without the intangibles in order to measure their influence on value and report the results without misleading the intended user. (emphasis added)

Market Analysis Issues

Certain specific steps should be taken when appraising subsidized property. Research with housing organizations and public agencies should be completed to find appropriate data on financing, rental and occupancy restrictions, resale restrictions, and sales of comparably subsidized or restricted properties. Knowledge of the general markets and the subsidized housing sub-markets should be evident in all analyses. The market analyses should also address the subject's ability to attract a sufficient number of subsidized tenants. Reversion projections should be based on interviews with market participants; any factual information from developments that have reached the expiration of their subsidies, incentives and restrictions; and other relevant information.

Legal Jurisdictions

Appraisers should be aware that some jurisdictions may have laws, administrative rules, regulations or ordinances that stipulate requirements in the valuation of subsidized housing within their jurisdiction. If so, appraisers, who are bound to utilize these requirements, comply with USPAP under the JURISDICTIONAL EXCEPTION.

This Advisory Opinion is based on presumed conditions

> without investigation or verification of actual circumstances. There is no assurance that this Advisory Opinion represents the only possible solution to the problems discussed or that it applies equally to seemingly similar situations. (emphasis added)

Mr McBurney's argument that a higher capitalization rate should be used is not supported by his exhibit 18, the Polton appraisal. Mr. Polton's appraisal arrived at a overall capitalization rate of 9.09% under the low-income scenario and 10.25% under the market rate scenario. The appraisal states:

> In order to estimate the capitalization rate, we contacted the Montana Board of Housing and interviewed Robert Morgan and Maureen Rude. We ascertained that the low income housing developments developed during the period spanned by this report was provided by a variety of conventional lenders. Specifically, several financings were arranged during 1994 based on rates of 8.25% to 9.5% on a twenty year amortization schedule. This is somewhat below conventional loans.

Mr. Polton's income approach under the low-income scenario is silent regarding the mortgage buy-down by HUD to 1% and that the term of the mortgage is 40 years as testified to by M. McBurney.

A portion of the Advisory Opinion AO-14 states:

> A critical factor in all subsidized housing appraisals is the analysis of whether or not the various subsidies, incentives and restrictions remain with the real property following a sale or foreclosure and are marketable property rights to be included in the appraisal.

Mr. McBurney testified that the mortgage arrangements along with the rent restrictions would remain with the property subsequent to a sale. It is the Board's opinion that the mortgage subsidy should be included in market value determination; therefore, the DOR's recognition of the mortgage subsidy is considered appropriate in valuing the subject property.

The letter of transmittal from the Polton appraisal states:

> ...I have considered all of the factors that affect the value of the subject property and I am of the opinion the Tangible Value and Proper Assessment, as of January 1, 1994 is $1,285,000...
>
> <u>DEFINITION OF MARKET VALUE</u>
>
> The most probable price, as of a specified date, in cash, or in terms equivalent to cash, or in other precisely revealed terms, for which the specified property rights should sell after reasonable exposure in a competitive market under all conditions requisite to fair sale, with the buyer and seller each acting prudently, knowledgeably, and for self-interest, and assuming that neither is under undue duress.
>
> Fundamental assumptions and conditions presumed in this definition are:
>
> 1. Buyer and seller are motivated by self interest.
>
> 2. Buyer and seller are well-informed and are acting prudently.
>
> 3. The property is exposed for a reasonable time in the open market.
>
> 4. Payment is made in cash, its equivalent, or in other precisely revealed terms.
>
> 5. Specified financing, if any, may be the financing actually in place, or on terms generally available for the property type in its locale on the effective date of valuation.

6. The effect, if any, of atypical financing, services, or fees on the market value of the property shall be clearly and precisely revealed in the appraisal report.

FUNCTION OF THE APPRAISAL

This appraisal is intended to serve as the basis for a determination of market value of the tangible real estate in connection with a tax appeal. As such, it is prepared in accordance with all applicable report writing requirements and Standards of Professional Practice of the Appraisal Institute.

AFFORDABLE HOUSING

The subject property is affordable housing. Affordable Housing is defined as follows:

Affordable housing may be defines (sic) as single- or multi-family residential real estate targeted for ownership or occupancy by low- or moderate-income households as a result of public programs and other financial tools that assist or subsidize the developer, purchaser, or tenant in exchange for restrictions on use and occupancy. The United States Department of Housing and Urban Development (HUD) provided the primary definition of income eligibility standard for low- and moderate-income households. Other federal, state and local agencies define income eligibility standards for specific programs and developments under their jurisdiction.

The subject property was developed under Section 236 program which subsidizes the interest payments of the mortgage loan and restricts occupancy to low income residents. The project is a limited dividend project and the returns on equity are limited to six percent of equity per annum, if available. The term of the restrictions on income have approximately twenty years remaining.

PROPERTY RIGHTS APPRAISED

The right or interest in the property being appraised is a fee simple estate. A fee simple estate is defined as follows:

> Absolute ownership unencumbered by any other interest or estate subject only to the limitations imposed by the governmental powers

> of taxation, eminent domain, police power, and escheat."

Mr. Polton's appraisal has established a value for the property appraised in Exhibit #11 using the income approach by a "low income scenario" and a "market rate analysis". The final determination of value is that of the "low income scenario". This value takes into consideration the rent restrictions imposed on that property. It should be noted that the property rights appraised are fee simple which Mr. Polton has defined as unencumbered in his appraisal. It is the Board's opinion the value determination and the property rights appraised are not consistent in that appraisal.

The Polton appraisal utilized a capitalization rate of 9.09% which was derived from the band of investment. In addition, an effective tax rate of 1.65% was utilized. The overall capitalization rate for the low income analysis from this report is 10.74%. Mr. Polton's total capitalization rate for the market rate analysis is 11.90%. This rate includes the same 1.65% effective tax rate.

The taxpayer's profit and loss statement shows a management fee of 11.2% (exhibit #14). The DOR applied a management fee of 7%. The Board agrees with Mr. McBurney's argument that the government involvement requires a management fee higher than that which is typical; therefore, a management fee of 11% is more appropriate for the subject property. The Polton appraisal has analyzed three years of operating expenses, therefore, actual management has been considered in his analysis.

The Board does not agree with Mr. McBurney's argument that the mortgage buy-down to 1% by HUD is not a benefit to the property. This mortgage buy down is one component of the HUD 236 Program which assists in the development and availability of low income housing. It is evident that the property's income could not cover the debt service without this subsidy. The HUD 236 Program needs to be analyzed as a whole when valuing a property of this type. Each component of the HUD 236 Program has an impact on the property's market value. It is the Board's opinion that recognizing only the rent restrictions and excluding the mortgage subsidy could be viewed an error or omission in determining the market value.

The Court instructed the DOR to do determine a value for the subject property from the income approach to value. The DOR did provide three values for the subject property derived from the income approach, but, as previously mentioned the Board finds little support in the exhibits presented which were used in the development of these values. The Board has been presented with a surplus of income information from other appraisals. The Polton appraisal has considered the low income program but, as previously stated, has given no recognition of the financing benefit which the Board has determined contributes value. The Board recognizes the fact that DOR appraisers are not subject to the provisions of USPAP, and they are involved in appraising property on a mass basis; but the methods and analysis employed by the DOR should be consistent with that of an independent fee appraiser. It is the Board's opinion that the most credible evidence presented of income approach to value is that which is in the Polton appraisal, exhibit 18, to which needs to added a financing benefit. The Board will not simply uphold the DOR's cost value when the value indication from the income approach is not supported by credible evidence. To do so would, in the opinion of this Board, rewards a substandard product. The Administrative Rules of Montana allows for the recognition of independent fee appraisals.

> 42.20.455 Consideration of Independent Appraisals as an Indication of Market Value, (1) When considering any objection to the appraisal of property, the department may consider independent appraisals of the property as evidence of the market value of the

> property. For an independent appraisal to be considered, the taxpayer or his/her agent must meet the following requirements. (emphasis added)

From the evidence and testimony of Mr. Dempsey, the DOR has given consideration to the various appraisals which have been submitted.

The Court also instructed this Board to reflect how the governmental restrictions are factored into the valuation. The Board has reviewed the original record, evidence and testimony from the taxpayer's agent and from the DOR. It is the Board's opinion, the correct value for the subject property is determined by the income approach from the low income analysis from the Polton appraisal, with the inclusion of the corrected financing benefit of $56,923.

There was a voluntary element to the restrictions or encumbrances on behalf of the investors. The investors had a choice regarding whether to receive favorable mortgage benefits and other financial compensation, i.e. accelerated deprecation, developers fees, etc., in return for a limited-dividend. Investors in this property chose to waive market income in exchange for the favorable mortgage benefits at the time this property became part of the low income program. Because investors had a choice whether to accept restrictions or encumbrances in exchange for certain financial benefits, nothing was taken from the owner/investors for the benefit of others. It is the Board's opinion that the DOR's method of applying a value to the mortgage subsidy is sound.

Based on the evidence and testimony, it is the Board's opinion the market value for the subject property as determined by the income approach to value is $1,814,665 as illustrated by the following:

96 income producing apartment units				
Apts Mo. Rent:	1 bedroom	48	$259	
	2 bedroom	36	$296	
	3 bedroom	12	$340	
INCOME				
Monthly rental income			$ 27,168	
Annualized			X 12	
Total			$326,016	
Other income			$ 12,650	
Potential Gross Income (PGI)			$338,666	
Occupancy			97%	
Total		$328,506		
Financing benefit			$ 56,923	
Effective Gross Income (EGI)			$385,429	
EXPENSES				% of EGI
Management			($ 42,397)	11%
Expenses			($148,137)	38%
Total Expenses			($190,534)	49.5%
Net Operating Income (NOI)		$194,895		50.5%
CAPITALIZATION				
Capitalization rate (OAR)			9.09%	
Effective tax rate			1.65%	
Total Rate			10.74%	

Value Indication	
NOI / Total Rate = Value	**$/per apt**
$194,895 / 10.74% = $1,814,665	**$18,902**

CONCLUSIONS OF LAW

1. **15-8-111, MCA**, Assessment - market value standard - exceptions. (1) All taxable property must be assessed at 100% of its market value except as otherwise provided.
(2) (a) Market value is the value at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.
(b) If the department uses construction cost as one approximation of market value, the department shall fully consider reduction in value caused by depreciation, whether through physical depreciation, functional obsolescence, or economic obsolescence.

2. **15-1-101 MCA**, Definitions (1)Except as otherwise specifically provided, when terms mentioned in this section are used in connection with taxation, they are defined in the following manner:
(e) The term "comparable property" means property that:
(i) has similar use, function, and utility;
(ii) is influenced by the same set of economic trends and physical, governmental, and social factors; and
(iii) has the potential of a similar highest and best use.
(o) The term "property" includes money, credits, bonds, stocks, franchises, and all other matters and things, real, personal, and mixed, capable of private ownership. (emphasis supplied)

3. **15-6-101 MCA**, Property subject to taxation - classification. (1) All property in this state is subject to taxation, except as provide otherwise.

4. **ARM 42.20.107**, Valuation Methods for Commercial Properties.
(1) When determining the market value of commercial properties, other than industrial properties, department appraisers will consider, if necessary information is available, an income approach valuation.
(2) If the department is not able to develop an income model with a valid capitalization rate based on the stratified direct market analysis method, the band-of-

investment method or collect sound income and expense data, the final value chosen for ad valorem tax purposes will be based on the cost approach to value. The final valuation is that which most accurately estimates market value.

5. **ARM 42.20.108**, Income Approach (1) The income approach is based on the theory that the value of income producing property is related to the amount, duration, and certainty of its income producing capacity. The formula used by the department to estimate the market value of income producing property through application of the income approach to value is V = I/R where:
(a) "V" is the value of the property to be determined by the department.
(b) "I" is the typical property net income for the type of properties being appraised; and
(c) "R" is the capitalization rate determined by the department as provided in ARM 42.20.109.
(2) The following procedures apply when valuing commercial property using the income approach:
(a) Typical property net income "I" shall reflect market rents not investment value income or other rents.
(b) Market rent is the rent that is justified for the property based on an analysis of comparable rental properties and upon past, present, and projected future rent of the subject property. It is not necessarily contract rent which is the rent actually paid by a tenant.
(c) The department will periodically request gross rental income and expense information from commercial property owners. Standard forms, developed by the department, will be used to collect the information statewide. Copies of those forms may be obtained by contacting the Department of Revenue, Property Assessment Division, Mitchell Building, Helena, Montana 59620.
(d) Additional methods of obtaining income and expenses information may consist of personal contacts or telephone contacts with owners, tenants, renters or leases, knowledgeable lending institution officials, real estate brokers, fee appraisers, or any other sources the appraiser deems appropriate including summarized data from recognized firms who collect income and expense

information, and appeal or court actions.
(e) The department will review and analyze all annual rental income and expense data collected. As necessary, that data will be adjusted to reflect average conditions and management before entering the data into the computer assisted mass appraisal system. The process must result in defensible estimates of potential gross rents, effective gross incomes, normal operating expenses, and normal net operating incomes.
(f) The department will follow established procedures for validating commercial sales information for the development of income models. Only valid sales will be used for the income and expense module of the computer assisted mass appraisal system.
(3) the department will use generally accepted procedures as outlined by the International Association of Assessing Officers in their titled "Property Assessment and Appraisal administration" when determining normal net operating income. The following is an example of the format which will be used:
(a) potential gross rent

less vacancy and collection loss
plus miscellaneous income
equals effective gross income
less normal operating expenses
equals normal net operating income

(b) Normal and allowable expenses include the cost of property insurance; heat, water, and other utilities; normal repairs and maintenance; reserves for replacement of items whose economic life will expire before that of the structure itself; management; and other miscellaneous item necessary to operate and maintain the property.
(c) Items which are not allowable expenses are depreciation charges, debt service, property taxes and business expenses other than those associated with the property being appraised.
(d) An effective tax rate will be included as part of the overall capitalization rate. (emphasis supplied)

6. **ARM 42.20.109**, Capitalization Rates (1) When using the income approach, the department will develop overall capitalization rates which may be according to use type, location, and age of improvements. Rates will

be determined by dividing the net income of each property in the group by its corresponding valid sale price. The overall rate chosen for each group is the median of the rates in the group. The final overall rate must include an effective tax rate.

(2) (a) If there are insufficient sales to implement the provisions of ARM 42.20.109 (1), the department will consider using a yield capitalization rate. The rate shall include a return of investment (recapture), a return on investment (discount), and an effective tax rate. The discount is developed using a band-of-investment method for types of commercial property. The band-of-investment method considers the interest rate that financial institutions lend on mortgages and the expected rate of return and average investor expects to receive on their equity. This method considers the actual mortgage rates and terms prevailing for individual types of property.

(b) A straight-line recapture rate and effective tax rate will be added to the discount rate to determine the yield capitalization rate.

7. **ARM 42.20.455** Consideration of Independent Appraisals as an Indication of Market Value, (1) When considering any objection to the appraisal of property, the department may consider independent appraisals of the property as evidence of the market value of the property. For an independent appraisal to be considered, the taxpayer or his/her agent must meet the following requirements. (emphasis supplied)

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ORDER

IT IS THEREFORE ORDERED by the State Tax

Appeal Board of the State of Montana that the subject property shall be entered on the tax rolls of Cascade County by the Assessor of said County at the 1994 tax year and subsequent tax years within that appraisal cycle of the value reflective of the income approach value $1,814,665 as determined by the Board.

Dated this 2nd of April, 1998.

BY ORDER OF THE
STATE TAX APPEAL BOARD

____
PATRICK E. McKELVEY, Chairman

(S E A L)

____
GREGORY A. THORNQUIST, Member

____
LINDA L. VAUGHEY, Member

NOTICE: You are entitled to judicial review of this Order in accordance with Section 15-2-303(2), MCA. Judicial review may be obtained by filing a petition in district court within 60 days following the service of this Order.